BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
FRANC0 WESTERN OIL COMPANY)

Appearances:

For Appellant: John B. Norberg, Certified Public Accountant

For Respondent: Harrison Harkins, Associate Tax Counsel

OPINION

This appeal is made pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of Franco Western Oil Company, a corporation, to his proposed assessment of additional tax for the taxable year ended December 31, 1937, in the amount of $563086.

The major portion of the proposed assessment resulted from the action of the Commissioner in disallowing $8,238.34 of the deduction claimed by Appellant on account of depletion of oil and gas property owned by it; Section 8(g) of the Act, as amended by Statutes 1935, p. 962, provides that:

> "The basis upon which depletion is to be allowed in respect of any property and the amount of depletion allowable shall be as provided in sections 113 and 114 of the said Revenue Act of 1934, which are, for the purpose of this subdivision, hereby referred to and incorporated with the same force and effect as though fully set forth herein."

The relevant provision of the Revenue Act of 1934 is Section 114(b)(3), which provides as follows:

> "In the case of oil and gas wells and allowance for depletion under section 23(m) shall be 27½ per centum of the gross-income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph."

The action of the Respondent in disallowing a portion of

the deduction resulted from the fact that in computing its net income from its oil and gas properties for the purpose of applying the 50 per cent limitation referred to in the above provision, the Appellant did not deduct from gross income the intangible drilling and development costs incurred by it with respect to the property, even though in somputing its net income for the purpose of determining the measure of its tax it elected to deduct the entire amount of such costs.

On this point the Appellant has attempted to show by reference to the legislative history of the Bank and Corporation Franchise Tax Act that in incorporating the provisions of the Federal Act the Legislature gave no consideration to the regulation of the United States Treasury Department (Regulation 74, Art. 221(i) requiring that taxpayers deducting intangible drilling and development costs in computing their taxable net income must likewise deduct such costs in computing net income for the purpose of applying the 50 per cent limitation upon the depletion allowance. There *is* no warrant, however, for the assumption that the validity of the Commissioner's action depends upon any implied adoption by the Legislature of the Federal regulation. The sole question for determination is whether the ruling of the Commissioner on this point represents an unreasonable interpretion of the term "net income , . from the property" as used in the Federal statute, and *on* this question the Appellant has the burden of proof. (See J. K. Hughes Oil Co. v. Bass, 62 F. (2d) 1'76).

While the failure of the Appellant to make any attempt to sustain this burden would appear sufficient of itself to justify the denial of any relief to it on this issue, a consideration of the difficulty involved in the treatment, for accounting purposes, of intangible drilling and development costs, and of the fundamental purpose of the depletion allowance, affirmatively establishes, in our opinion, that the action of the Commissioner was reasonable and was based upon a correct interpretation of the statutory provision. From the standpoint of strict accounting theory, the proper classification, as capital outlays or as current expenses, of amounts expended in the drilling of oil and gas wells and in the preparation of the same for production may vary with the circumstances presented in individual cases; and the uncertainties and hazards of the business may often justify, or even require, the charging against current operations of ep enditures that would otherwise be treated as capital outlays, (See Paton, Accountant's Handbook (2d ed.) pp. 500-504). It is undoubtedly because of these considerations that for income tax purposes the regulations of the United States Treasury Department have for a number of years accorded to taxpayers the option of either capitalizing such expenditures or of treating them as current expenses. (See Montgomery, Auditing Theory and Practice (5th ed.) p. 568.) It appears that the Commissioner has allowed a similar option in the computation of net income under the Bank and Corporation Franchise Tax Act, even prior to the promulgation of Article 8(g) 2 of his Regulations, which makes express provision therefc

Although under the percentage method the amount is more

or less arbitrary, the deduction for depletion is accorded in recognition of the fact that an oil or gas well is a wasting asset, and the fundamental purpose of the deduction is to make an allowance, in the computation of net income, for the portion of the asset which is used up in production. (United States v. Dakota-Montana Oil Co., 288 U. S. 459, 467; Helvering v. Bankline Oil Co., 303 U. S. 362, 366.) It is apparent that when a taxpayer electes to charge its intangible drilling and development costs against current operations, the above purpose is served by the allowance of a smaller amount than when such expenditures are captialized. Consequently, it seems entirely consistent with the purpose of the Xct that when a taxpayer has elected to treat such costs as deductions from gross income in computing the measure of the tax, such expenditures should likewise be treated 'as deductions in computing net income for the purpose of applying the 50 per cent limitation on the depletion deduction. Regulations of the United States Treasury Department expressly requiring that such a procedure be followe were upheld in Helvering v. Wilshire Oil Co., 308 U. S. 90, and F. H. E. Oil Co. v. Helvering, 308 U. S. 104.

The other items making up the proposed assessment consist of expenses incurred in the State of Arizona in the amount of $4,783.00, the deductibility of which was questioned by the Respondent on the ground that they were not applicable to California operations, and oil royalties in the amount of $1,722.23 received from holdings in the State of Wyoming. Sinc the assessment was proposed the Respondent has concluded that the entire business of Appellant during the income year in question was done within this State, so that under Section 10 o the Act the tax must be measured by its entire net income. He therefore concedes that the expenses incurred in Arizona constitute a proper deduction, but reaffirms his previous position that the oil royalties from holdings in Wyoming must be included in the measure of the tax.

In our opinion, this position is correct. Section 10 of the Act specifically provides that:

> "If the entire business of the . . . corporation is done within this State, the tax shall be according to or measured by its entire net income .."

There is nothing in the record to warrant the conclusion that the Appellant was doing business in Wyoming or in any state except California. The mere ownership of an interest in real property and the receipt of income therefrom does not constitute doing business in the state in which the property is located. Appeal of Gilmore Oil Co., Nov. 15, 1939; Appeal of Filtrol Co. of California, Nov. 15, 1939. It follows that under Section 10 Appellant's entire net income must be included in the measure of the tax.

O R D E R

Pursuant to the views expressed in the opinion of the Boar! on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the action of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of Franco Western Oil Company, a corporation, to a proposed assessment of additional tax in the amount of $563.86 for the taxable year ended December 31, 193'7, based upon the income of said corporation for the year ended December 31, 193(be and the same is hereby modified as follows: Said Commissior is hereby directed to allow a deduction from Appellant's gross income in the amount of $4,783.00, said amount being the expenses incurred by Appellant in the State of Arizona during the income year 1936. In all other respects, the action of the said Commissioner is hereby affirmed.

Done at Sacramento, California, this 7th day of July, 1942, by the State Board of Equalization.

R. E. Collins, Chairman
Wm. G. Bonelli, Member
George R. Reilly, Member
Harry B. Riley, Member

ATTEST: Dixwell L. Pierce, Secretary